GOVERNANCE

The covenant question

Peter Carvill explores how the relationship between schemes and sponsors is shifting, and how it varies across Europe

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In late February this year, Sir Philip Green, the former owner of the UK department chain British Home Stores (BHS) made an agreement with The Pensions Regulator (TPR) to surrender £363 million of his own money in order to shore up the pension schemes of the now-defunct retailer. In return, the regulator agreed to end its enforcement action against Green.

BHS arrangement

The arrangement between Green and TPR brings something of an end to the ongoing drama revolving around the chain, which collapsed in 2016 with the loss of 11,000 jobs across 164 stores. Green's Arcadia Group had sold BHS in 2015 for £1 to former racing driver and three-time bankrupt Dominic Chappell. Following the firm's subsequent collapse, Green was hauled over the coals by British MPs for paying himself dividends worth about £400 million from the company while leaving its pension fund with a £571 million deficit. All in all, the situation saw around 20,000 pensions seemingly at risk.

The arrangement means that those stakeholders yet to retire will not suffer the 10 per cent cut to their benefits they would have if the schemes had been transferred to the Pension Protection Fund. Under the new arrangements, a new pension fund for BHS employees, overseen by three independent trustees and set up by TPR, will be made available. Benefits from that will match more closely those that had existed in the BHS schemes.

Earlier reports placed Green's initial offer at a much-lower £80 million, half of which was to be a loan from the Arcadia group to BHS. The £283 million, or more than 450 per cent, increase between the reported initial offer and Green's final settlement was probably a shrewd move aimed at limiting further potential costs.

Green's willingness to settle and the manner in which he was excoriated within the media underline the responsibility that many see employers as having to their company's DB schemes. This is generally reflected in the employer covenant, which is essentially the understanding between schemes and their sponsors as to the responsibilities, duties, and commitments of the latter.

Covenant areas

Any covenant needs to cover a number of areas, including contingency plans in the case of an employer's insolvency, senior

management track records, and the corporate and capital structure of the employer. As such, this undertaking is far more complex than a single document. The UK's Pensions and Lifetime Savings Association (PLSA) policy lead for EU and International James Walsh says: "There isn't a single covenant document. What exists is because of the trustees and the rules and the relationship in which they conduct themselves. You can't just go to a filing cabinet and get a copy."

So how important is the employer covenant? And what is the best definition of its function in regards to a DB scheme?

In 2010, TPR released *The Employer Covenant at a Glance*. That guide stated: "The employer plays a vital role as scheme sponsor and effectively underwrites the risks that the scheme is exposed to, including the underfunding, longevity, investment, and inflation."

Trustee firm PTL managing director Richard Butcher says that employers have two principal functions in relation to DB schemes. "Those," he says, "are the funding and the underwriting. The employers pay in a reasonable contribution but, in the event that something unforeseen happens, they're there to pick up the tab. You can't have a DB pension scheme without some party that's willing to underwrite it."

PLSA head of governance and investment Joe Dabrowski says the covenant's importance within the UK is underscored by the fact that four out of five DB schemes within the UK are currently in deficit.

"The strength of a scheme is interwoven with the strength of the covenant," he adds. "There are ways in which the ropes between employers and the scheme can be cut, essentially when the employer is insolvent or the scheme does so well that it can buy out its liability with an insurer. But most of the time, they're in a merry dance with one another."

Heavy relationship

The relationship between schemes and their sponsors, and the weight this has put on the covenant, has shifted measurably in recent years, although it is hard to objectively measure. The key reasons for this shift, though, remain a rapidly-greying population, an economy still battered from the financial turmoil that erupted in 2008, and a changing pensions landscape in which the number of DB schemes is shrinking in comparison to their DC counterparts. Dabrowski estimates that only 10-15 per cent of DB schemes are still open to new members.

"We expect the bulk of schemes to reach maturity in the next 10-15 years," Dabrowski adds, "so they'll be paying out more in pensions than they receive in contributions. Those things are harder to manage than when schemes are younger, especially when returns were greater due to previous macroeconomic circumstances. The need for greater governance and the strength of the actions you take is ever more important then."

And this is without mentioning the problems posed by an economic landscape still reeling from 2008. In October 2016, the PLSA released its *DB Task Force: Interim Report.* That report states, "[…] the current

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system is highly fragmented and requiring ever-increasing amounts of capital from corporate sponsors while at the same time attempting to reduce risk for members and sponsors. The pressures DB schemes are under are being made worse by the current economic climate. And the many risks and costs in the system are simultaneously placing strain on scheme sponsors and the wider economy."

European variations

While the covenant is of special importance to the UK, the landscape across Europe varies dramatically, from a similar setup in Ireland to a completely-different landscape within the Netherlands.

For starters, the pension landscape is more consolidated in the Netherlands compared to the UK, due to its much-wider use of multi-employer pension schemes. "There," says Walsh, "the covenant plays no part, despite it having the largest pension sector among the member states. The schemes there have to be 100 per cent funded all the time. If they are not, you look at other safety valves such as reducing pensions, which is something you can't do in the UK. We rely more here in the UK on the employer being strong to demonstrate that the scheme is a strong institution."

Quantum Advisory partner Rhidian Williams goes further, saying that the Netherlands has been more stringent in the funding of DB schemes. The most recent statistics, he says, show that funding levels for Dutch schemes are over 100 per cent. "The covenant," he says, "is still important but not as important as it is in the UK. The key point there is the time horizon and the issue of what would happen if the employer was not around. If that was the case, we'd have to remove risk or go to a buyout."

Perhaps the most similar to the UK is Germany. Giving the caveat that he cannot speak in detail about Europe, Butcher points out a system similar to the UK. "It's quite reliant," he says, "on the covenant as it uses book reserve schemes. Rather than funding, liability is allowed."

Overall, though, Williams says that despite a shrinking in the proportion of schemes on a DB basis, there is a lot more focus on the employer covenant and recent years has seen it move up the agenda. He adds, "Trustees should be looking at the current and future prospects of the employer; over 10 or 15 years, you want to hope that they are still around and paying into the fund."

"Better understanding," he concludes, "leads to better outcomes. Having a better hand on the covenant is a win-win situation in that it should lead to more-informed results." ■